

FTB NOTICE

California Franchise Tax Board - Legal Division



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FTB NOTICE 92-9

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SUBJECT: Substantial Understatement Penalty Guidelines; Corporations Subject to IRS Coordinated Examination Program

Introduction

AB 274 (Stats. 1990, Ch. 452) added Revenue and Taxation Code section 25935, incorporating by reference Internal Revenue Code section 6662, relating to the accuracy-related penalty, which includes the penalty applied to the portion of any underpayment attributable to any substantial understatement of tax (§6662(d).)

Internal Revenue Code section 6662(d)(2)(B) allows a reduction in the amount of the understatement for that portion of the understatement attributable to:

- (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
- (ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or on a statement attached to the return.

The Internal Revenue Service has provided an administrative exception to the statutory requirement that relevant facts be shown on the original return by providing for an automatic waiver of all or part of the penalty where the taxpayer shows additional tax or makes an adequate disclosure on a "qualified amended return" as defined in Treas. Reg. section 1.6661-2(d)(2). Rev. Proc. 85-26, 1985-1 C.B. 580 provides a special procedure for taxpayers that are subject to the Coordinated Examination Program (CEP). Specifically, it allows waiver where items are disclosed within ten days of certain specific IRS actions commencing an audit for the year. As California has no regulations directly on point, federal regulations and procedures will apply, as modified for California as set forth below.

Because CEP taxpayers are effectively not required to make disclosure on the original federal return, the California return, to which the original federal return is attached, will also not disclose such items. This Notice provides procedures for such taxpayers to make disclosure for California purposes when a California audit commences.

California Procedures

In the case of additional tax shown or adequate disclosure made on a "qualified California amended return," the penalty will automatically be waived. A qualified California amended return is defined, generally, as an amended

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return filed after the due date of the return and before the time a taxpayer is first contacted by the Franchise Tax Board concerning an examination of the return. In the case of a CEP taxpayer, a written statement furnished by the taxpayer to the Franchise Tax Board examining agent responsible for examining its return is treated as a qualified California amended return if the written statement is furnished after the due date of the return and before the day that is 45 days after the earliest of:

1. the day the taxpayer first receives a written confirmation of a scheduled field audit appointment; or
2. the day the taxpayer formally meets with the examining agent with respect to the examination of the relevant taxable year; or
3. the day taxpayer first receives a written request for information with respect to the examination of the relevant taxable year.

The statement furnished by the taxpayer to the examining agent responsible for examining its return must include the following:

1. the caption "Furnished under FTB Notice 92-9";
2. a description of the nature and the amount of all items that would result in adjustments and that the taxpayer would have reported if, in lieu of furnishing a written statement, the taxpayer had then filed a properly completed amended return; and
3. the following declaration signed by a person authorized to sign the return of the taxpayer: "Under penalties of perjury, I declare that I have examined this written statement and, to the best of my knowledge and belief, this written statement is true, correct and complete."

A written statement need not include a recomputation of tax liability. Similarly, if an item automatically affects another item, the written statement need not include a recomputation of the affected item. For example, if the taxpayer's written statement identifies an increase in ending inventory and states the amount of the increase, an item resulting in adjustments has been described with the required specificity. The written statement need not include a recomputation of tax liability resulting from the increase in ending inventory. Similarly, the written statement need not identify the existence and amount of the decrease in the cost of goods sold that results from the increase in ending inventory.

Any additional tax liability that would result from adjustments identified in such a written statement shall be treated as an additional amount of tax shown on a qualified California amended return. Similarly, if, on such a written statement the taxpayer makes adequate disclosure with respect to an item, such disclosure shall be treated as adequate disclosure made in a statement attached to a qualified California amended return.

This Notice applies to returns for income years beginning on or after January 1, 1990 and for examinations commencing after the date of this Notice.

DRAFTING INFORMATION

The principal author of this notice is Bruce R. Langston of the Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Langston at the Franchise Tax Board Legal Division, P.O. Box 1468, Sacramento, CA 95812-1468.